2010-2011-2012-2013

THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

HOUSE OF REPRESENTATIVES

TAX LAWS AMENDMENT (2013 MISCELLANEOUS MEASURES NO. 1) BILL 2013: INVESTMENT MANAGER REGIME

EXPOSURE DRAFT - EXPLANATORY MEMORANDUM

(Circulated by the authority of the
Treasurer, the Hon Chris Bowen MP)

Table of contents

Glossary

The following abbreviations and acronyms are used throughout this explanatory memorandum.

Abbreviation	***Definition***
ATO	Australian Taxation Office
CGT	Capital gains tax
IMR	Investment Manager Regime
IT(TP) Act 1997	*Income Tax (Transitional Provisions) Act 1997*
ITAA 1997	*Income Tax Assessment Act 1997*
MIT	Managed investment trust
TAA 1953	*Taxation Administration Act 1953*
The Johnson Report	*Australia as a Financial Centre Report* – November 2009.

Chapter 1
Reforms to the Investment Manager Regime

Outline of chapter

1.1 Schedule # to this Bill amends the *Income Tax Assessment Act 1997* (ITAA 1997) to introduce the third element of the Investment Manager Regime (IMR). These reforms expand the existing exemption available for qualifying investment income of certain foreign widely held managed funds if they are residents of information exchange countries and meet information reporting requirements.

1.2 Schedule # also amends aspects of the first two elements of the IMR that were enacted in the *Tax Law Amendment (Investment Manager Regime) Act 2012*. These changes apply to previous income years to which the first two elements of the IMR applied and include modifications to the widely held and closely held tests, as well as other technical amendments.

1.3 All legislative references in this Chapter are to the ITAA 1997 unless otherwise stated.

Context of amendments

1.4 The development and introduction of an IMR was a recommendation of the *Australia as a Financial Centre: Building on our Strength - Report by the Australian Financial Centre Forum* (the Johnson Report). That report noted that the uncertainties and scope of Australia's tax system could act as an impediment to certain cross-border activities. The introduction of an IMR, under which clear and comprehensive statutory rules for the taxation of foreign residents' investment income would be provided, was proposed as a means of addressing impediments to investment activity into Australia, and through Australia using Australian financial service intermediaries.

1.5 In addition, the *Australia's Future Tax System: Report to the Treasurer* recommended (at recommendation 35) improvements to Australia's conduit income arrangements for managed funds. Under the rules applying at the time, some income that could be considered 'conduit income' was potentially taxable in Australia due to it being treated as

Australian sourced as a result of being attributable to an Australian permanent establishment.

1.6 Representations from the managed funds industry also highlighted issues with complying with the US Accounting Standard ASC 740-10 (widely known as 'FIN 48'), which requires funds reporting under the US Generally Accepted Accounting Principles to make provision for potential tax exposures from 'uncertain' tax positions. Where a fund is not exchange traded, a tax provision of this kind can affect its net asset value and unit redemption price. Industry advised the Government that, as a result of this FIN 48 issue, many funds were reviewing whether to continue investing in Australia.

1.7 As part of the 2010-11 Budget, the Government provided in-principle support for the introduction of an IMR and released a discussion paper entitled *'Developing an investment manager regime: improving conduit income arrangements for managed funds'*.

1.8 The Government subsequently announced the first two elements of the IMR:

- Element 1 would address the 'FIN48' issue reported by industry through amendments to the law to restrict the Commissioner of Taxation's ability to raise assessments in respect of certain investment income earned by particular foreign managed funds during the 2010-11 and earlier income years;

- Element 2 would address potential tax uncertainty where a widely held foreign managed fund engaged an Australian-based financial services intermediary for certain portfolio investments. In particular, element 2 would ensure that income from such investments would be exempt from Australian tax if the only reason it was taxable was because the fund engaged the financial services intermediary. This element would apply from the 2010-11 income year and is also known as the 'conduit income exemption'.

1.9 These first two elements were enacted in the *Tax Laws Amendment (Investment Manager Regime) Act 2012*, which received Royal Assent in September 2012.

1.10 As part of the reforms, the Government also requested that the Board of Taxation prepare a report on the design of an IMR as part of its review of the taxation of collective investment vehicles.

1.11 On 16 December 2011, the Minister for Financial Services and Superannuation responded to the Board's Report, announcing that the Government would introduce the third and final element of the IMR.

- Element 3 extends the IMR so that a broader range of investments are exempt from Australian tax. Element 3 does this in two ways. First, it extends the exemption for certain portfolio investments where the fund has a permanent establishment in Australia (but only because it engages an Australian intermediary) to include those investments it makes directly into Australia. Second, it extends the exemption to non-portfolio investments through Australia, to the extent that an Australian-based intermediary has been engaged.

1.12 On 21 December 2012, the Minister for Financial Services and Superannuation further announced that amendments would be made to the existing 'widely held' and 'concentration' tests. These tests apply to all elements of the IMR.

Operation of the current law

1.13 Consistent with international tax principles, Australia generally taxes its residents on their worldwide income and taxes foreign residents on their Australian sourced income.

1.14 But for the existing IMR rules, a foreign managed fund that invests into or through Australia would generally be taxed on all income from Australian sources and on capital gains that arise in relation to 'taxable Australian property'.

1.15 As identified in the Johnson Report, particular questions must be answered in determining whether a foreign resident is liable to pay tax in Australia. Such questions can include whether the foreign resident has a permanent establishment in Australia, whether the foreign resident's income is Australian sourced, and whether that income is on capital or revenue account.

1.16 By modifying the general tax treatment of investments made by an 'IMR foreign fund', Subdivision 842-I (which introduced element 2 of the IMR) seeks to address some of the uncertainties that can arise in applying these concepts.

1.17 Subdivision 842-I does not apply to all foreign resident entities. To qualify for the IMR, an entity must be an 'IMR foreign fund'. IMR foreign funds must pass a widely held test, not breach a concentration test,

be a resident of an information exchange country, give an annual information statement to the Commissioner, and cannot:

- be an Australian resident at any time during the income year; or
- undertake or control a trading business in Australia at any time during the year.

1.18 The widely held and concentration tests are key aspects of the IMR as they determine the types of entities that can access the regime. The widely held test ensures that the fund is a genuine collective investment vehicle in which a number of investors pool their resources. The concentration test supports the widely held test by ensuring that a small number of the investors collectively do not hold a significant proportion of the interests in the fund. It also acts as an important integrity measure, reducing the risk that the IMR is used by Australian residents for tax deferral purposes.

1.19 The exemption available under Subdivision 842-I is restricted to passive investments made by qualifying funds. As such, Subdivision 815-I is limited to returns or gains from financial arrangements with entities in which a fund holds a total participation interest of less than 10 per cent, and over which the fund cannot exercise substantial influence.

1.20 Returns or gains from qualifying investments are exempt or disregarded under Subdivision 842-I where they would otherwise be included as Australian sourced assessable income because the fund has a permanent establishment in Australia, and the permanent establishment exists solely as a result of the fund engaging an Australian intermediary (for example, an investment manager). This treatment ensures that Australia does not assert source-based taxing rights in respect of the overseas investment income of foreign residents simply because they engage Australian managers, agents or service providers.

1.21 Deductions or losses made in the course of deriving returns or gains to which Subdivision 842-I applies are disregarded in calculating the foreign fund's Australian tax position.

1.22 Special rules are also included under Subdivision 842-I to ensure that the IMR exemption only flows to foreign resident beneficiaries and partners where the IMR foreign fund is a trust or partnership.

Interaction with FIN48 (IMR element 1)

1.23 As well as introducing element 2 of the IMR under Subdivision 842-I, the *Tax Laws Amendment (Investment Manager Regime) Act 2012*

enacted element 1 through amendments to the *Income Tax (Transitional Provisions) Act 1997* (IT(TP) Act 1997). The amendments were introduced to overcome potentially adverse consequences of FIN 48 by removing any uncertainty over the tax positions of foreign funds that had invested in Australia in the 2010-11 and previous income years.

Summary of new law

1.24 The purpose of element 3 of the IMR is to provide certainty in relation to the Australian income tax treatment of returns and gains from particular financial arrangements of qualifying widely held foreign funds. In doing this, it is intended that the IMR remove the need for such funds to determine whether income from such investments is on capital or revenue account.

1.25 To achieve this, in respect of financial arrangements with entities in which an IMR foreign fund holds a portfolio interest, the amendments extend the current exemption to include the investments the fund makes directly into Australia if it has a permanent establishment in Australia solely as a result of engaging an Australian intermediary.

1.26 In addition to this change, the amendments extend element 2 of the IMR (the conduit income measure) to financial arrangements with entities in which an IMR foreign fund holds a non-portfolio interest. To ensure that this extension only applies to conduit income (income from investments overseas), the permanent establishment test under the current law (which no longer applies to portfolio interests) is retained in respect of financial arrangements with entities in which an IMR foreign fund holds a non-portfolio interest.

1.27 The amendments also introduce additional eligibility criteria that an entity must satisfy for it to be an IMR foreign fund. In conjunction with the existing requirements, a fund must be a resident of an information exchange country and submit an information statement to the Commissioner of Taxation (Commissioner) in respect of each income year that it is an IMR foreign fund.

1.28 In addition to a technical correction to ensure that the existing trading business criterion operates appropriately, a further rule is included that prevents an entity from qualifying as an IMR foreign fund if it controls another entity that carries on a trading business in Australia. This rule is consistent with other trading business tests in the tax law and ensures that the Australian trading business test cannot be circumvented by a fund that interposes another entity to carry on a trading business in Australia.

1.29 The amendments also change the existing widely held test and concentration test (which is renamed as the 'closely held test'). The revised closely held test applies to each member of the fund (rather than any entity that holds an interest), and introduces additional requirements in respect of interests in the fund that are held by a single entity. Under these new requirements, a fund will breach the closely held test if a single member holds a total participation interest of 10 per cent in the fund, or if the sum of the total participation interests of a manager of the fund and its associates is 20 per cent or more.

1.30 Although direct interests in a fund might be held by a small number of entities, when taking into account the underlying interests in the fund held by those entities, it could be the case that the fund is in substance widely held and not closely held. In order to ensure that the widely held and closely held tests apply appropriately in such instances, the amendments introduce special rules for determining the members of a fund and for applying the closely held test. These rules count individuals as members where they hold their interest in the fund indirectly through one or more interposed entities.

1.31 The amendments also introduce new rules for applying the widely held and closely held test when interests in the fund are held by 'IMR widely held entities' (which include certain foreign resident and Australian resident entities), and where interests in the fund are held by related individuals and other entities acting in a nominee capacity.

1.32 Under the current law, the widely held and closely held tests must be complied with at all times during an income year. To ensure the widely held and closely held tests apply with appropriate flexibility, the amendments introduce an additional rule for inadvertent breaches of short duration. Under this rule, a fund that breaches the widely held or closely held tests can retain its status as an IMR foreign fund for an income year provided that it is not in breach for more than 30 days in the income year, and the fund (or an entity responsible for the fund) and its associates were unable to prevent the breach from occurring.

1.33 The amendments also include a 'start-up' rule to complement the existing 'wind-down' rule. Consistent with the existing 'wind-down' rule, the widely held and closely held tests are deemed to be satisfied when a fund is in its start-up period. Integrity rules are included to ensure that this start-up rule only applies to entities that ultimately become IMR foreign funds, and to ensure that the start-up and wind-down phase rules cannot be used consecutively.

Comparison of key features of new law and current law

New law	*Current law*
Changes to the definition of IMR foreign fund	
To be an IMR foreign fund for an income year, an entity must be a resident of an information exchange country at all times during the income year.	No equivalent
To be an IMR foreign fund for an income year, an entity must lodge an information statement in respect of the income year with the Commissioner in the approved form.	No equivalent
To be an IMR foreign fund for an income year, an entity must not carry on or control a trading business in Australia at any time during that income year.	To be an IMR foreign fund for an income year, an entity must not carry on a trading business at any time during that income year.
IMR foreign widely held entities (foreign life insurance companies and certain foreign superannuation and pension funds) are deemed to be widely held and not closely held.	No equivalent.
In determining whether a fund is widely held, entities that are interposed between a fund and individual interest holders or IMR widely held entities are disregarded. Individuals are treated as members of the fund, and IMR widely held entities are allocated 50 notional individual members.	In applying the widely held test, the ordinary membership rules (which relate to direct interests in the fund) apply.
In determining whether a fund is closely held, the total participation interests of its members (as determined under the widely held test) are assessed. A fund will be closely held if a member holds a total participation interest in the fund of 10 per cent or more or if 10 or fewer members of the fund have a combined total participation interest in the fund of 50 per cent or more. A fund will also be closely held if the	In determining whether a fund breaches the concentration test, the total participation interest of any entity that holds an interest in the fund is assessed. A fund will breach the concentration test if 10 or fewer entities have a combined total participation interest in the fund of 50 per cent or more.

sum of the total participation interests of a manager of the fund and its associates is 20 per cent or more. Any interests in the fund that are held by notional individual members are disregarded in applying the closely held test to the fund.	
In determining whether a fund is widely held and not closely held, direct participation interests of one entity in another that are voting interests are disregarded.	In determining whether a fund is widely held or breaches the concentration test, all direct participation interests are taken into account.
Where a fund inadvertently breaches the widely held or closely held tests during an income year, it is treated as being widely held and not closely held provided it is not in breach of the tests for more than 30 days during the income year.	No equivalent.
A start-up period rule (with relevant integrity rules) deems an entity to be widely held and not closely held for a period of 12 months. This period commences on the day the entity was created.	No equivalent.
Changes to covered financial arrangements	
A return or gain from a financial arrangement that is with an entity in which an IMR foreign fund holds a non-portfolio interest (determined in accordance with section 960-195) can be IMR income or an IMR capital gain if it is attributable to an Australian permanent establishment that only existed because the fund engaged an Australian intermediary.	A return or gain from a financial arrangement with an entity in which an IMR foreign fund holds a total participation interest of 10 per cent or more will not be IMR income or an IMR capital gain.

Detailed explanation of new law

Objects of Subdivision 842-I of ITAA 1997

1.34 The objects of the Subdivision have been updated to reflect the changes introduced by the amendments. The revised IMR has two objectives, each of which is broadly consistent with those of the original Subdivision.

1.35 The first objective is to address uncertainty that exists as a result of certain aspects of Australia's taxation laws and the impediments that this uncertainty may have on particular international investments made into or through Australia. ***[Schedule #, item 3, paragraph 842-205(1)(a)]***

1.36 This uncertainty arises in respect of the Australian income tax consequences for certain widely held foreign managed funds in two areas. The first area relates to the Australian tax status of returns or gains that are made by a foreign fund that has engaged an Australian-based agent, manager or service provider to negotiate and conclude contracts on its behalf. The second area relates to the direct investment of foreign widely held managed funds in Australian assets and whether or not the return or gain from those assets is on capital or revenue account.

1.37 The second objective of the Subdivision is to ensure that Australia retains its taxing rights in respect of the worldwide income of its residents and continues to tax foreign resident taxpayers on their returns and gains from most taxable Australian property. ***[Schedule #, item 3, paragraph 842-205(1)(b)]***

Changes to the definition of 'IMR foreign fund'

1.38 The IMR is only available for an entity that qualifies as an 'IMR foreign fund' in respect of a particular income year. In this respect, the criteria for being an IMR foreign fund perform a fundamental role in ensuring that the scope of the regime is consistent with the policy that it only apply to widely held foreign collective investment vehicles. (For simplicity, references to a 'fund' hereinafter refer to an entity that might seek to apply the relevant criteria in order to determine whether or not it is an IMR foreign fund).

1.39 Currently under Subdivision 842-I, a fund cannot be an IMR foreign fund in relation to an income year if at any time during the income year it is an Australian resident, a resident trust estate, or carries on a trading business. These criteria are intended to ensure that the IMR only applies to foreign funds that do not undertake active businesses in Australia.

1.40 In addition, a fund must satisfy the widely held test at all times during the income year and must not breach the concentration test at any time during the income year. These tests are designed to ensure that eligible funds are genuine collective investment vehicles, and that a small group of investors does not hold a significant proportion of the interests in the fund.

1.41 The amendments to Subdivision 842-I introduce two additional criteria that must be satisfied in order for a fund to be an IMR foreign fund in respect of an income year. These criteria require that the fund:

- be a resident of an 'information exchange country' at all times during the income year; and
- submit an information statement to the Commissioner in relation to the income year.

1.42 In respect of the existing criteria, the amendments modify:

- the requirement for an entity not to be carrying on a trading business; and
- the widely held test; and
- the concentration test (which the amendments rename the 'closely held' test).

1.43 The amendments also introduce new rules that apply to the widely held and closely held tests. These changes introduce:

- rules to count the members of the fund and their total participation interests in it; and
- rules about inadvertent breaches of the widely held and closely held tests; and
- rules about a fund's 'start-up period'.

Additional criteria for being an IMR foreign fund

The fund must be a resident of an information exchange country

1.44 The amendments introduce the additional requirement that, to be an IMR foreign fund in relation to an income year, a fund must at all times during that year be a resident of an information exchange country. ***[Schedule #, item 6, paragraph 842-230(1)(aa)]***

1.45 'Information exchange country' is defined by subsection 12-385(4) in Schedule 1 to the *Taxation Administration Act 1953* (TAA 1953). Residence of an information exchange country is explained in subsection 12-390(7) in Schedule 1 to the TAA 1953.

1.46 This requirement is appropriate given the concessional nature of the IMR, and the potential for limited access to information to undermine the Commissioner's ability to effectively administer regimes that include

tests that relate to offshore arrangements. The information exchange country residency requirement provides the Commissioner with better access to information in respect of eligible funds and their members, and is consistent with broader efforts by Australia and other countries to promote effective information exchange globally as a means of combatting tax avoidance.

1.47 Given that this requirement has been introduced to ensure the Commissioner has access to appropriate information, the test can still be satisfied where a fund changes its residence from one information exchange country to another during an income year (the requirement is in relation to 'an' information exchange country, rather than 'a single' information exchange country).

An information statement must be provided to the Commissioner

1.48 As a result of the amendments, an annual information statement must be provided to the Commissioner in respect of the fund in order for it to qualify as an IMR foreign fund for that income year. ***[Schedule #, item 6, paragraph 842-230(1)(d)]***

1.49 The purpose of this rule is to require IMR foreign funds to notify the Commissioner that they have accessed the regime in respect of an income year. Although funds must also be residents of information exchange countries in order to qualify as IMR foreign funds, the self-assessment nature of the IMR means that eligible entities are relieved from the need to lodge a tax return in respect of income or gains to which the IMR applies.

1.50 In the absence of the information statement, the lack of formal reporting requirements would significantly impede the Commissioner's ability to identify when a fund has obtained the benefit of the IMR, and as a result, whether or not such funds have applied the relevant eligibility criteria appropriately. The inclusion of the information statement requirement overcomes this issue by ensuring that only funds that have reported their status as IMR foreign funds to the Commissioner are permitted to access the IMR.

1.51 In addition to the provision of an information statement to the Commissioner, notification in respect of the fund's status as an IMR foreign fund must also be provided to the foreign resident beneficiaries and foreign resident partners of an IMR foreign fund that is a trust or partnership.

Annual information statement

1.52 While the link between a fund's status as an IMR foreign fund and the provision of the information statement to the Commissioner is

contained in Subdivision 842-I, the obligation to provide the information statement to the Commissioner is imposed separately. ***[Schedule #, item 27, subsection 395-5(1) in Schedule 1 to the TAA 1953]***

1.53 The entity on which the obligation to submit the information statement falls depends on what type of entity the fund is. Where it is:

- a body corporate – the obligation is imposed on the fund;
- a trust – the obligation is imposed on the trustees;
- a partnership – the obligation is imposed on the partners;
- another type of entity – the obligation is imposed on an entity with responsibility for the day-to-day management of the fund.

[Schedule #, item 27, subsection 395-5(2) in Schedule 1 to the TAA 1953]

1.54 The information statement must be in the approved form, and must be provided to the Commissioner within three months of the end of the relevant income year. ***[Schedule #, item 27, subsections 395-5(3) and (4) in Schedule 1 to the TAA 1953]***

1.55 The three month time period is therefore intended to strike a balance between providing adequate time for the relevant entity to prepare and submit the information statement to the Commissioner, while ensuring that sufficient time remains for funds and other entities, such as the beneficiaries or partners of the fund, to finalise their Australian tax positions in the event that they are required to lodge an income tax return for that income year.

1.56 The information statement is intended to provide the Commissioner with information in respect of the name and address of the fund, the country or countries of which the fund was resident during the income year, the fund's status as an IMR foreign fund, and the application of Subdivision 842-I to the fund for the income year. ***[Schedule #, item 27, subsection 395-5(5) in Schedule 1 to the TAA 1953]***

1.57 Although the amendments describe the types of information required in the information statement, the references to such information do not limit the information that may be required in the approved form. ***[Schedule #, item 27, subsection 395-5(6) in Schedule 1 to the TAA 1953]***

1.58 As such, in addition to the specified types of information required, the information statement could be used to collect information relevant to the underlying policy intent of the regime and to inform any future analysis of the regime.

1.59 In determining whether an entity is an IMR foreign fund for the purpose of Division 395, the requirement in the eligibility criteria for being an IMR foreign fund in respect of the provision of an information statement to the Commissioner is disregarded. ***[Schedule #, item 27, section 395-15 in Schedule 1 to the TAA 1953]***

1.60 This rule addresses a circularity issue that arises from Division 395 applying in respect of IMR foreign funds, and an entity's status as an IMR foreign fund being contingent on the provision of the statement required under Division 395 to the Commissioner. As a result of this rule, the other criteria for an entity being an IMR foreign fund are relevant in determining whether an entity is required to provide a statement to the Commissioner in respect of an income year. The provision of the completed information statement to Commissioner will then satisfy the information statement requirement for the entity under paragraph 842-230(1)(d) for that income year.

Notification to other entities

1.61 In addition to providing an information statement to the Commissioner in respect of an income year, the trustee of a trust, or the partner with day-to-day responsibility for the management of a partnership, that is an IMR foreign fund under Division 395 must provide a written notice to each of the foreign resident beneficiaries or foreign resident partners of the fund. This written notice must state that the relevant entity or entities consider the fund to be an IMR foreign fund for the income year. ***[Schedule #, item 27, subsections 395-10(1) to (3) and (5) in Schedule 1 to the TAA 1953]***

1.62 This notification is required because a trust or partnership's status as an IMR foreign fund will have direct consequences for the Australian tax position of its foreign resident beneficiaries or foreign resident partners. As such, whether or not the trust or partnership has satisfied the criteria for being an IMR foreign fund will be relevant for each beneficiary or partner of the fund.

1.63 Where an entity that is required to provide written notice publishes the relevant information on a website in a way that is readily accessible to a fund's foreign resident beneficiaries or foreign resident partners, that entity will be treated as having provided written notification to each of the fund's foreign resident beneficiaries and foreign resident partners. ***[Schedule #, item 27, subsection 395-10(4) in Schedule 1 to the TAA 1953]***

1.64 In the event that written notification is required, it must be provided by the date that the information statement to the Commissioner is due (that is, within three months of the end of the relevant income year). ***[Schedule #, item 27, subsection 395-10(6) in Schedule 1 to the TAA 1953]***

1.65 Although in practice it is expected that the required information statement will need to be submitted to the Commissioner before notifying beneficiaries and partners (given that the fund's status as an IMR foreign fund under Subdivision 842-I is contingent upon the provision of the information statement to the Commissioner), the same three month time limit applies for the notification. As with the information statement for the fund, the three month period for notifying foreign resident beneficiaries and foreign resident partners is intended to provide those entities with sufficient time to finalise their Australian tax position in the event that they are notified that the fund is not an IMR foreign fund.

1.66 In contrast to the information statement requirement, a failure to notify foreign resident beneficiaries or foreign resident partners will not result in an entity being precluded from being an IMR foreign fund under Subdivision 842-I.

1.67 Instead, an entity that fails to notify a fund's foreign resident beneficiaries or foreign resident partners when it was required to do so will be liable to an administrative penalty under Subdivision 286-C in Schedule 1 to the TAA 1953 (which relates to penalties for failing to provide documents on time). ***[Schedule #, item 24, subsection 286-75(2BB) in Schedule 1 to the TAA 1953]***

1.68 Administrative penalties for failing to provide a notification to a foreign resident beneficiary or a foreign resident partner are calculated consistently with other administrative penalties under Subdivision 286-C, and will result in a fund being liable for 1 penalty unit for each entity it fails to notify, for each 28 day period that it fails to do so, up to a maximum of 5 penalty units for each failure. ***[Schedule #, item 25, paragraph 286-80(2)(b) in Schedule 1 to the TAA 1953]***

Funds that are 'IMR foreign widely held entities'

1.69 Under the current law, a fund will pass the widely held test and not breach the existing concentration test if all of its membership interests are held by one or more 'foreign widely held entities'. The amendments introduce further rules in respect of 'IMR foreign widely held entities'. New rules for applying the widely held and closely held tests to funds whose interests are held by IMR foreign widely held entities are described in further detail below at paragraphs 1.147 to 1.165.

1.70 In addition to those revised rules, the amendments introduce a new rule that deems a fund which is itself an IMR foreign widely held entity to pass the widely held test and not breach the closely held test. ***[Schedule #, item 6, paragraph 842-240(3)(a)]***

1.71 This rule overcomes potential compliance or technical issues associated with tracing through foreign widely held entities to identify and

quantify underlying interests. The rule is consistent with the existing foreign widely held test given that a fund will currently pass the widely held test and not breach the existing concentration test if it is wholly owned by a foreign widely held entity.

1.72 As a result, an entity will be an 'IMR foreign widely held entity' under the revised rules if it is:

- a foreign life insurance company at all times during the income year; or
- a foreign superannuation fund that has at least 50 members; or
- an entity established by an exempt foreign government agency for the principal purpose of funding pensions for the citizens or other contributors of a foreign country.

[Schedule #, item 6, subsection 842-243(1)]

Foreign life insurance companies

1.73 The amendments change the current reference to a 'life insurance company that is not an Australian resident' to 'a foreign life insurance company'. ***[Schedule #, item 6, paragraph 842-243(1)(a)]***

1.74 The expression 'foreign life insurance company' describes a foreign resident company whose sole or principal business is life insurance. In contrast, the term 'life insurance company' describes an entity that is registered under the *Life Insurance Act 1995* and is used in the widely held test provisions contained in the Managed Investment Trust (MIT) withholding rules (which apply to Australian residents rather than foreign residents).

1.75 This meaning of 'foreign life insurance company' is more appropriate for the purpose of the IMR foreign widely held entity rules than one based on the more restrictive 'life insurance company' definition. Under the IMR, the question of whether a company is registered under the *Life Insurance Act 1995* is not directly relevant to whether they should be considered to be widely held and not breach the closely held test. Moreover, it is expected that the majority of resident and foreign resident insurance companies registered under the *Life Insurance Act 1995* would carry on a trading business in Australia. As such, foreign resident 'life insurance companies' will generally be precluded from being IMR foreign funds despite the fact that they would pass the widely held test and not breach the closely held test.

Changes in respect of the existing criteria for being an IMR foreign fund

New rules for 'start-up periods'

1.76 In addition to the existing 'wind-down' rule, the amendments introduce two 'start-up period' rules which apply to newly created funds. Both of these rules affect the way in which the eligibility criteria for being an IMR foreign fund are applied to a newly created fund. ***[Schedule #, item 6, subsection 842-235(2).***

1.77 The first start-up rule operates generally in respect of the income year in which a fund was created (the 'start-up year'). Under this rule, the proportion of the start-up year during which the fund was in existence is deemed to be the entire income year for the purposes of determining whether the fund was an IMR foreign fund in relation to that income year. ***[Schedule #, item 6, paragraph 842-235(2)(a).***

1.78 This rule addresses the fact that some of the eligibility criteria for being an IMR foreign fund (such as the information exchange country residency requirement and the widely held test) must be satisfied *at all times* during an income year. The rule allows criteria of this kind to be satisfied even if parts of the start-up year occurred before the fund was created.

1.79 The second start-up rule deems a fund to satisfy the requirement that it pass the widely held test and not breach the closely held test for a period of 12 months. This 12 month period commences on the day the fund was created. ***[Schedule #, item 6, paragraph 842-235(2)(b)***

1.80 This rule recognises that newly created funds are likely to be engaged in the process of attracting new investors. During this time, the ownership interests in a fund may not be sufficiently diverse for it to qualify as an IMR foreign fund under the widely held and closely held tests. This start-up period rule is therefore designed to allow newly created funds that ultimately become IMR foreign funds to access the IMR during this 12 month period.

1.81 The provision of a fixed 12 month period under this rule ensures consistent treatment in respect of the widely held and closely held tests, irrespective when during its start-up year a fund was created.

1.82 Because the second start-up period rule applies for 12 months from the date a fund is created, it will always have application in respect some part of the following income year (for example, if a fund was created on the first day of an income year, the 12 month start-up period rule will apply on the first day of the next income year).

Claw-back rule for the start-up period

1.83 The 12 month start-up period rule is only intended to apply to newly created funds that ultimately become IMR foreign funds. In order to ensure this outcome, the amendments introduce an integrity rule (referred to as the 'claw-back' rule) to ensure that investors cannot perpetually circumvent the widely held and closely held tests by moving investments between newly created funds in each income year.

1.84 The claw-back rule applies if a fund is not an IMR foreign fund in relation to its second income year, or ceases to exist during that year. Where the claw-back rule applies, any previous application of the 12 month start-up period rule to the fund during its start-up year (and for the applicable portion of the following income year) is cancelled. ***[Schedule #, item 6, subsection 842-235(3)]***

1.85 As stated above, in determining whether a fund is an IMR foreign fund in respect of the second income year, the 12 month start-up period rule will continue to deem the fund to be widely held and not closely held for the portion of the second income year to which the rule applies. This will mean that a fund will only need to be widely held and not closely held as a matter of fact for the part of the second income year that is not covered by the 12 month period.

1.86 The claw-back rule only applies where a fund relied upon the 12 month start-up period rule to be an IMR foreign fund in its start-up year. Where a fund was actually widely held and not closely held in respect of the start-up year (and therefore did not need to rely on the 12 month start-up period rule) a failure by that fund to be an IMR foreign fund for the second income year will not affect its status as an IMR foreign fund for the start-up year.

1.87 Where the claw-back rule applies, a fund that made IMR income or IMR capital gains during the year in which it was created will retrospectively lose its status as an IMR foreign fund and be required to re-characterise its IMR income or IMR gains as assessable income. As such, any taxpayers who obtained a benefit from the IMR as the result of the start-up period rules applying to the fund will have their income tax assessment referable to the fund's start-up year amended. They would have to lodge an income tax return if they had not already done so.

Extension of the general amendment period in respect of the claw-back rule

1.88 Under the general amendment periods, the Commissioner ordinarily has four years from when a notice of assessment is issued to amend the assessment (or two years for individuals and small business entities).

1.89 The standard amendment periods do not provide the Commissioner with sufficient time to administer the claw-back rule because it can take until the end of the second income year to determine whether or not the rule needs to be applied.

1.90 If a taxpayer's assessment needs to be amended because a fund applied the 12month start-up period rule but was either not an IMR foreign fund in respect of the second income year, or ceased to exist during that income year, the Commissioner may amend the assessment within 7 years after the notice of assessment for the start-up year was issued. ***[Schedule #, item 20, section 842-275]***

1.91 This time period strikes a balance between providing certainty to taxpayers in respect of their Australian tax affairs, and providing the Commissioner with sufficient time to administer the claw-back rule.

Changes to the rule for 'wind-down periods'

1.92 The amendments also replace the existing rule for the wind-down phase with two rules for a fund's wind-down period.

1.93 Consistent with the new start-up period rule, where a fund ceases to exist during an income year, the period of that income year during which the fund existed is treated as being the entire income year for the purposes of determining whether the fund is an IMR foreign fund in relation to that income year. ***[Schedule #, item 6, subsection 842-235(4) and paragraph 842-235(5)(a)]***

1.94 As with the equivalent start-up period rule, this wind-down period rule ensures that the criteria for being an IMR foreign fund that must be satisfied at all times during an income year are only applied to those parts of the income year during which the fund actually existed.

1.95 The amendments modify the existing wind-down phase rule in order to improve its application. As a result of these changes, the widely held test is treated as being satisfied, and the closely held test is treated as not being breached, at all times during the fund's final year while it was in existence (note, the period of existence is now also treated as being the entire income year due to the first wind-down period rule). ***[Schedule #, item 6, subsection 842-235(4) and paragraph 842-235(5)(b)]***

<u>Interaction between the start-up period and wind-down period rules</u>

1.96 Consistent with the existing wind-down phase rule, the new wind-down period rules introduced by the amendments can only be applied where a fund was an IMR foreign fund for the previous income year. ***[Schedule #, item 6, paragraph 842-235(4)(b)]***

1.97 In conjunction with the claw-back rule (which applies if a fund does not exist throughout its second income year and it relied on the 12-month start-up period rule), the requirement that a fund was an IMR foreign fund in respect of the previous income year ensures that wind-down period rules do not apply in a fund's second income year if the fund needed the second start-up period rule to be an IMR foreign fund in its first income year.

1.98 If a fund attempted to apply the wind-down period rule in its second income year in such circumstances, the claw-back rule would apply to its start-up year (on the basis that the fund was not in existence throughout the second income year) and it would lose its status as an IMR foreign fund for the start-up year. The fund would then be precluded from applying the wind-down period rules in respect of the second income year on the basis that it had not been an IMR foreign fund in relation to the previous income year.

Changes to the 'trading business' criteria

1.99 The amendments make a technical change to the criteria related to the carrying on of a trading business by a fund by correcting the omission of the words 'in Australia' from the existing law. Consistent with the original policy intent, this amendment ensures that a fund is precluded from being an IMR foreign fund if it carries on a trading business *in Australia*, as opposed to carrying on a trading business elsewhere. ***[Schedule #, item 6, subparagraph 842-230(b)(i)]***

1.100 The amendments also introduce a further rule that prevents a fund from being an IMR foreign fund for an income year if at any time during the income year it *controls* a trading business in Australia, or is able to directly or indirectly control the affairs or operation of a trading business in Australia. ***[Schedule #, item 6, subparagraph 842-230(b)(ii)]***

1.101 This further rule improves the integrity of the existing trading business requirement by ensuring that a fund cannot avoid the proscription on carrying on a trading business in Australia by the expedient of transferring the business to another entity it controls. The trading business rules are included in the definition of IMR foreign fund to ensure that the IMR does not provide an exemption in respect of active income that relates to an Australian trading business.

1.102 As with the original trading business criteria, this further rule is based upon Division 6C of the ITAA 1936. Consistent with section 102N of Division 6C (which defines a trading trust as a unit trust that either carries on a trading business, or directly or indirectly controls a trading business), the concept of 'control' is not a defined term. As such, the

question of whether a fund controls a trading business in Australia is to be determined according to the term's ordinary meaning.

1.103 The inclusion of this additional requirement is also consistent with recommendation 5 of the Board of Taxation's 2011 report to the Assistant Treasurer (*Review of an Investment Manager Regime as it relates to Foreign Managed Funds)* that, to qualify for an IMR, a foreign managed fund should not carry on or control a trading business in Australia.

Changes to the widely held test

1.104 The IMR is not intended to apply to all foreign resident entities. Rather, one of the key policy principles for the regime is that it only applies to investments made through genuinely widely held collective investment vehicles. The scope of the regime in this regard is predominantly driven by the proposition that the returns or gains derived by foreign resident individuals who make investments into or through Australia are likely to be on capital account. In contrast, a collective investment made by a large number of individuals (say though a collective investment vehicle) is more likely to be treated on revenue account given the scope and magnitude of the collective investment.

1.105 The IMR is therefore designed to put the individual foreign resident investors back in the position they would have been in had they made their share of the collective investment directly. Having regard to this policy intent, it would not be appropriate to extend the IMR to entities that are not widely held, because in such cases it is less likely that there will be a change in the character of the returns made by the entity as the result of the pooling of individual investments. Put another way, investment returns that are derived by a closely held entity are more likely be of the same character as a direct investment made one of the entity's individual investors. In such cases, the question of whether or not a return or gain is on revenue or capital account (and therefore taxable in Australia) can be appropriately determined under the general law.

1.106 In conjunction with the closely held test, the widely held test therefore plays the fundamental role of ensuring that only genuinely widely held entities are able to access the IMR. In order to be an IMR foreign fund for an income year, an entity must be widely held at all times during the income. This test ensures that only funds that are collective investment vehicles are able to access the IMR.

1.107 The amendments replace the current widely held test with a revised test. The amendments also make a number of significant changes to the way the widely held test is applied, namely through the introduction of special rules for counting the number of members of a fund where

interests in the fund are held through one or more interposed entities. These new membership counting rules are discussed in detail at paragraphs 1.140 to 1.146 below.

1.108 The changes to the widely held test are to allow genuinely widely held entities to more accurately count the underlying holders of their interests. It is expected that as a result, a greater number of entities will be able to satisfy the widely held test.

1.109 Three of the ways that a fund can currently satisfy the widely held test continue to apply under the revised test:

- if the units or shares of the entity are listed on an approved stock exchange; or
- if the entity has 25 or more members (now determined in accordance with the new membership counting rules); or
- if the entity is of a kind specified in regulations.

[Schedule #, item 6, paragraphs 842-240(1)(a), (b) and (d)]

1.110 In respect of circumstances where an entity has 25 or more members, the part of that rule related to ignoring the objects of a trust in counting the number of members has been moved from the widely held test itself, and relocated to the provisions setting out the rules for counting members. ***[Schedule #, item 12, paragraph 842-240(1)(b)]***

1.111 As a result of these changes, a fund will no longer automatically satisfy the widely held test if one or more IMR foreign widely held entities have a total participation interest in the fund of more than 25 per cent. Similarly, an entity will not be taken to be widely held because all of its membership interests are held, directly or indirectly, by one or more entities that themselves would satisfy the other components of the existing widely held test. Such funds will however be allocated a number of notional members in accordance with the new membership counting rules. ***[Schedule #, item 6, subsection 842-240(1)]***

1.112 Removing these components of the widely held test does not mean that funds that would have been widely held as a result of those aspects of the test can no longer be widely held. Those components were originally included in the widely held test as a proxy for counting underlying members, and are not required given the new membership counting rules.

Changes to the concentration test (renamed as the closely held test)

1.113 In order to be an IMR foreign fund for an income year, an entity must not breach the closely held test at any time during the income year. ***[Schedule #, item 6, paragraph 842-230(2)(b)]***

1.114 This test has been renamed from the 'concentration test' to improve the consistency of these rules with the MIT withholding rules (which contain a 'closely held' test that performs a similar function).

1.115 The closely held test operates in conjunction with the widely held test and ensures that a substantial proportion of the interests in a fund is not held by a small number of entities despite the fund having a large number of members. (Note, the above discussion at paragraphs 1.104 to 1.106 in respect of the policy rationale for the widely held test is equally applicable to the closely held test).

1.116 In contrast to the concentration test, which applied to the total participation interests of other entities in the relevant fund, the closely held test only applies to the total participation interests of the funds' *members*. This means that interposed entities that are not counted as members for the purpose of the widely held test are similarly disregarded for the purpose of applying the closely held test to the fund. ***[Schedule #, item 6, subsection 842-240(2)]***

1.117 Special rules are also included for calculating the total participation interests of those members. These rules are discussed in further detail below at paragraphs 1.138 to 1.170 and are relevant for determining whether a fund breaches the closely held test.

1.118 A fund will breach the closely held test if:

- any one of the fund's members holds a total participation interest in the fund of 10 per cent or more (determined in accordance with the new membership counting rules); or
- the sum of any 10 or fewer of the members' total participation interests in the fund comes to 50 per cent or more (determined in accordance with the new membership counting rules); or
- the sum of the total participation interests in the fund of a manager of the fund and its associates comes to 20 per cent or more.

[Schedule #, item 6, subsection 842-240(2)]

The 10 per cent rule in respect of the members

1.119 In contrast to the concentration test, the closely held test includes a rule which examines the members individually to ensure that no single member holds a total participation interest of 10 per cent or more in the fund. ***[Schedule #, item 6, paragraph 842-240(2)(a)]***

1.120 This rule improves the integrity of the closely held test by ensuring that a fund breaches the closely held test if one or more of its members holds a substantial proportion of its interests.

The 20 per cent rule in respect of the managers

1.121 In addition to the 10 per cent rule, further rules are included under the closely held test that ensure the managers of a fund, or an entity that controls a manager of the fund, cannot hold a total participation interest of 20 per cent or more in the fund. ***[Schedule #, item 6, paragraphs 842-240(2)(c) and (d)]***

1.122 This rule ensures that where a fund is managed by an entity that is not an individual, that entity cannot derive a significant proportion of the economic benefit of the fund. Although the 10 per cent rule already has effect in respect of individual managers, the tracing rules that are now available in respect of individual members would allow a non-individual manager to derive a substantial proportion of the economic benefit of a fund, if interests in that manager are held by a sufficient number of individuals.

1.123 In applying the 20 per cent closely held rule to the managers of a fund, the membership and total participation interest counting rules in respect of disregarding interposed entities (described at paragraphs 1.140 to 1.146 below) and in respect of IMR widely held entities (described at paragraphs 1.147 to 1.165 below) do not apply. ***[Schedule #, item 6, subsection 842-242(2)]***

1.124 Those rules only apply to the application of the widely held and closely held tests to a fund in respect of its members, rather than in respect of the calculation of a fund's managers' interests. To the extent that the 10 per cent rule applies to a fund manager in its capacity as a member of the fund, however, the abovementioned rules will continue to apply.

The 50 per cent rule in respect of the members

1.125 The aspect of the closely held test related to the combined participation interests of 10 or fewer fund members is broadly consistent with the existing concentration test. The focus on the members of the fund rather than on any entity with an interest in the fund ensures that the closely held test is better targeted. The operation of the test is also

clarified to ensure that it applies to the aggregated participation interests of the relevant members, rather than to each member individually. ***[Schedule #, item 6, paragraph 842-240(2)(b)]***

Regulation making power in respect of funds

1.126 An additional rule is also included so that certain types of entities that might otherwise breach the closely held test can be prescribed by regulation as not breaching the test. ***[Schedule #, item 6, paragraph 842-240(3)(b)]***

1.127 This regulation making provision is included for similar reasons to the equivalent rule in respect of the widely held test. The provision recognises that some flexibility may be required to accommodate new circumstances.

Special rule for unpreventable circumstances of short duration

1.128 As a general rule, a fund can only be an IMR foreign fund for an income year if at 'all times' during the income year it was both widely held and not closely held. The amendments introduce a special rule for temporary inadvertent breaches of the widely held and closely held tests.

1.129 In conjunction with other changes introduced by the amendments, this rule increases the flexibility of the eligibility criteria for being an IMR foreign fund by providing relief from the 'at all times' nature of the widely held and closely held tests. This treatment is only extended to funds that are widely held and not closely held for substantially all of the income year but both temporarily and inadvertently breach the widely held or closely held tests.

1.130 The rule permits a fund to disregard one or more circumstances that occur during an income year which would otherwise cause the fund not to be widely held, or cause it to be closely held, at a time in an income year. ***[Schedule #, item 6, subsection 842-240(6)]***

1.131 For example, where a fund has 25 members during an income year, but one of those members exits the fund, the fund would fail the widely held test for that income year as the result of it not being widely held (in the absence of another member joining at the same time).

1.132 The rule applies to circumstances that cause a fund to breach the widely held or closely held tests if:

- the circumstances could not have been prevented by a trustee or a manager of the fund (or one of their associates); and

- no more than 30 days with such circumstances occurred in the income year.

[Schedule #, item 6, subsections 842-240(4) and (5)]

1.133 Where a particular circumstance continues beyond a single day, each day to which it applies is counted for the rule. Similarly, if a number of circumstances operate separately during the income year, each of the days in which one or more of the circumstances applies is counted for the rule. ***[Schedule #, item 6, paragraphs 842-240(4)(a) and (b)]***

1.134 A day is also covered by this rule if at a point during that day, an entity is treated as being widely held and not closely held as the result of the start-up period rule. ***[Schedule #, item 6, paragraph 842-240(4)(c)]***

1.135 Days to which the start-up period rules apply are included in this 30 day limit in order to prevent a fund from first relying upon the start-up period rule in an income year, and then applying this rule to a part of the income year not covered by the start-up period rule. Allowing a fund to use both rules in that way would significantly undermine the claw-back rule (which requires a fund to be an IMR foreign fund in respect of the part of the second income year not covered by the 12 month start-up period rule).

1.136 Because the rule is intended to apply in respect of inadvertent breaches only, a circumstance cannot be disregarded in applying the widely held or closely held tests to the fund if the circumstance was caused by, or could have been prevented by, a trustee or manager of a fund (or one of its associates).

1.137 These limitations are appropriate because they ensure that a fund cannot continue to be an IMR foreign fund if it breaches the widely held and closely held test for an extended period of time. A fund that is not widely held or is closely held for a significant proportion of an income year cannot be described as being widely held and not closely held, even if that is only the result of inadvertent breaches of the tests.

New rule for counting members and total participation interests

1.138 The amendments introduce new rules for determining the members of a fund in applying the widely held and closely held tests, as well as the total participation interests of those members in applying the closely held test. ***[Schedule #, item 6, subsection 842-242(1)]***

1.139 These rules significantly alter the way the widely held and closely held tests apply to a fund by disregarding interposed entities and counting underlying interest holders. In contrast, Subdivision 960-G

(general rules for determining members of entities) only counts those entities with direct interests as members.

Membership is traced through interposed entities to individuals

1.140 Where an individual holds an interest in a fund indirectly through one or more interposed entities, that individual is counted as a member of the fund, and any interposed entities are taken not to be members (even if they hold a direct interest in the fund). ***[Schedule #, item 6, subsection 842-242(3)]***

1.141 Given that in the majority of cases, an interest a fund will ultimately be held by an individual, this rule would be expected to apply in most circumstances where some of the interests in a fund are directly held by an entity that is not an individual. Tracing through to underlying individuals in identifying the members of a fund focuses the widely held and closely held test on the interest holders who receive an economic benefit from the fund, and who therefore benefit from the fund accessing the IMR. Interposed entities that are traced through to identify underlying members are disregarded in order to prevent double counting.

1.142 The rule about disregarding the objects of a trust in counting the members of a fund is moved from the widely held test to the rules about determining the members of a fund. ***[Schedule #, item 6, subsection 842-242(6)]***

1.143 Where related individuals each holds a separate interest in the fund, those individuals are together treated as a single individual. Where two or more individuals are treated as one individual, that notional individual is treated as having a total participation interest in the fund equal to the sum of their individual total participation interests. ***[Schedule #, item 6, subsections 842-242(7) and (8)]***

1.144 These rules ensure that all members of a family are treated as a single individual for the purposes of the widely held test. Aggregation in this way is appropriate given that the widely held and closely held tests are fundamentally concerned with measuring the level of economic benefit that individuals obtain from a fund accessing the IMR, and the fact that family members will often have interrelated economic interests.

1.145 Similarly, where an entity holds a total participation interest in a fund as nominee of another entity, the other entity is treated as holding the nominee's interest, and the nominee and its own interest in the fund are disregarded for the purposes of applying the widely held and closely held tests to the fund. ***[Schedule #, item 6, subsection 842-242(9)]***

1.146 This rule ensures that the widely held and closely held tests accurately measure the economic benefit that an individual is entitled to receive from a fund. To avoid double counting under those tests, to the

extent they would otherwise apply to the other entity, both the entity and the interests that it holds are disregarded.

Rules for deeming members where interests in the fund are held by IMR widely held entities

1.147 In addition to the rules in respect of funds that are IMR *foreign* widely held entities, the amendments introduce special rules which apply where an interest in a fund is held by an IMR widely held entity. These rules are included to overcome potential issues associated with tracing through entities that themselves have a significant number of members, or that, for technical reasons, cannot be traced through despite being widely held in nature.

1.148 The list of IMR widely held entities is intended to be broadly consistent with the equivalent MIT provisions, although the rules in respect of each list apply differently because of key differences between the two regimes.

1.149 An entity is an IMR widely held entity if it is:

- an IMR foreign widely held entity; or
- an IMR domestic widely held entity; or
- a foreign collective investment vehicle covered by paragraph 12-402(3)(e) in Schedule 1 to the TAA 1953; or
- a foreign sovereign wealth fund that is covered by paragraph 12-402(3)(g) in Schedule 1 to the TAA 1953.

[Schedule #, item 6, subsection 842-243(3)]

1.150 The rules for when an entity will be an 'IMR foreign widely held entity' are described at paragraphs 1.72 to 1.75 above).

1.151 As with the references to foreign collective investment vehicles and sovereign wealth funds, the definition of 'IMR domestic widely held entity' refers to entities listed in paragraphs 12-402(3)(a)(b)(c)(d) or (h) in Schedule 1 to the TAA 1953 (the MIT provisions).

1.152 As with the other types of IMR widely held entities, there can be practical or technical issues with tracing through certain widely held domestic entities. Although Australian resident entities cannot receive a tax benefit from the IMR, the inclusion of IMR domestic widely held entities in the list of IMR widely held entities addresses such issues by allowing the special membership rules to apply to them for the purposes of determining whether a fund is widely held or closely held.

1.153 In accordance with the MIT provisions referred to above, an entity is an IMR domestic widely held entity if it is:

- a life insurance company; or
- a complying superannuation fund, or a complying approved deposit fund, that has at least 50 members; or
- a pooled superannuation trust that has at least one member that is a complying superannuation fund with 50 or more members; or
- a MIT; or
- an entity established by and wholly-owned by an Australian government agency.

[Schedule #, item 6, subsection 842-243(2)]

1.154 To overcome potential compliance or technical issues related to the general tracing requirement, for the purposes of the widely held and closely held tests, an IMR widely held entity is deemed to be wholly owned by a notional number of individuals. ***[Schedule #, item 6, paragraph 842-242(4)(a)]***

1.155 Deeming the notional members to be individuals has two important effects. First, these notional individuals are counted as members of the fund and the IMR widely held entity is deemed not to be a member of the fund. Second, because all of the membership interests in the IMR widely held entity are taken to be held by individuals, the requirement to trace through the interests of any entities that are interposed between the IMR widely held entity and actual individuals is removed.

1.156 The number of notional members of an IMR widely held entity (with one minor exception) is worked out by determining its total participation interest in the fund, multiplying that number by 50 and rounding the result to the nearest number. ***[Schedule #, item 6, paragraph 842-242(4)(b)]***

1.157 The effect of this rule is that 50 individual members are allocated to an IMR widely held entity. As a result, where an IMR widely held entity holds a total participation interest of 50 per cent or more in a fund, the fund will have 25 notional individual members and so pass the widely held test (in that case, the fund is taken to have half of the IMR widely held entity's 50 members). Consistent with the MIT provisions, 50 is chosen as this is generally the minimum number of members that

such an entity must have in order to qualify as one of the listed widely held entities.

1.158 Because the closely held test applies to the total participation interests of each member (including the notional members of an IMR widely held fund), the amendments treat the total participation interest in the fund of each of the notional members as nil. ***[Schedule #, item 6, paragraph 842-242(4)(c)]***

1.159 The effect of this rule is that interests in a fund that are held by an IMR widely held entity are disregarded for the purposes of applying the closely held test to the fund. This treatment is appropriate given that a fund will not breach the closely held test if it is itself an IMR foreign widely held entity, or if all of its interests are held by IMR widely held entities.

1.160 The membership counting rules described above do not apply to interests held in a fund by an IMR widely held entity that is covered by paragraphs 12-402(3)(e) or (g) in Schedule 1 to the TAA 1953(foreign collective investment vehicles and foreign sovereign wealth funds). As a result of this limitation, where these types of IMR widely held entities (as well as any entity that controls an IMR widely held entity of that kind) holds a total participation interest in a fund of 50 per cent or more, the special membership counting rules in respect of notional individual members do not apply ***[Schedule #, item 6, paragraph 842-242(4)(a) and subsection 842-242(5)]***

1.161 This limitation ensures that, where an IMR widely held entity that is a foreign collective investment vehicle or foreign sovereign wealth fund holds a majority interest in a fund, the fund is not allocated notional members in respect of that interest. The rule that disregards interposed entities and traces through to underlying individuals can however still be applied to such entities.

1.162 Foreign collective investment vehicles are treated in this way rather than being included on the list of IMR foreign widely held entities because the widely held tests and closely held tests (rather than the criteria in paragraph 12-402(3)(e) in Schedule 1 to the TAA 1953) are specifically intended to apply to funds that are collective investment vehicles (if foreign collective investment vehicles of this kind were included on the list of IMR foreign widely held entities, they would always be deemed to be widely held and not closely held).

1.163 The inclusion of foreign collective investment vehicles on the list of IMR widely held entities is intended to address practical issues associated with applying the tracing rule for individuals.

1.164 Similarly, the IMR is not intended to apply to foreign sovereign wealth funds simply because of their status as sovereign wealth funds (however, in the event that a sovereign wealth fund satisfied the eligibility criteria for being an IMR foreign fund in its own right, it would be able to access the IMR as an IMR foreign fund).

1.165 Foreign sovereign wealth funds have been included on the list of IMR widely held entities in recognition of the fact that they often make investments through other collective investment vehicles. Because of the nature of the ownership structure of most sovereign wealth funds, there may be issues with applying the new tracing rules to their share of an interest in a fund. The 50 per cent threshold for interests held by sovereign wealth funds is included to ensure that notional members are only allocated to a sovereign wealth fund where it does not own substantially all of the interests in a fund.

Voting interests are disregarded in calculating direct participation interests

1.166 The widely held and closely held tests both rely upon identifying the interests held in a fund by other entities. Such interests may be held directly by the actual members of the fund, or indirectly through one or more interposed entities. To the extent that the widely held and closely held tests require the identification or calculation of a direct participation interest of one entity in another entity, direct participation interests that are voting interests are disregarded. ***[Schedule #, item 6, subsection 842-242(10)]***

1.167 Disregarding voting interests recognises that the role of the closely held test is to ensure that the IMR is not able to be used by a fund that is a vehicle for pursuing the economic interests of a small group of investors. If voting interests were counted under the closely held test, funds in which economic interests are in fact sufficiently diverse could be prevented from being IMR foreign funds.

1.168 It is not uncommon for a significant proportion of the voting rights in a fund to be retained by a small number of entities that are responsible for the management of the fund. For example, in the case of a fund that is a corporate limited partnership, it is common for the majority of the voting rights in the fund to be retained by a general partner (who might exercise those rights directly, or delegate that function to an agent acting as a fund manager).

1.169 Although removing voting interests permits a small group of members to retain significant voting rights, the 10 per cent rule (referred to at paragraphs 1.119 and 1.120 above) and the 20 per cent rule for managers (referred to at paragraphs 1.121 to 1.124 above) prevents the IMR from applying to funds in which a substantial proportion of the economic benefit accrues to a single member or to the managers of a fund.

1.170 In contrast to the closely held test, the widely held test does not measure the quantum of the interest that a member has in a fund. This rule, however, means that an individual or foreign widely held entity that only holds a voting interest in a fund will not be counted as a member of the fund. As with the closely held test, this outcome is appropriate because the widely held test is intended to determine the number of entities that have an economic interest in a fund.

Changes to financial arrangements covered by section 842-245

1.171 In addition to modifying the criteria that a fund must satisfy to qualify as an IMR foreign fund, the amendments also change the types of financial arrangements to which the IMR applies.

Changes to the portfolio interest requirement

1.172 Currently, in order for a return or gain from a financial arrangement to qualify as IMR income or an IMR gain, the financial arrangement must satisfy the criteria set out in existing section 842-245. Under that section, a return or gain from a financial arrangement cannot be IMR income or an IMR capital gain if the financial arrangement is with an entity in which an IMR foreign fund holds a total participation interest of 10 per cent or more.

1.173 The amendments change the mechanism for measuring the level of interest that an IMR foreign fund has in the other entity. Rather than measuring the total participation interest it holds (including indirect interests held through interposed entities), the revised rules apply the non-portfolio interest test contained in section 960-195. ***[Schedule #, item 10, paragraph 842-250(1)(b)]***

1.174 An entity is taken to have a non-portfolio interest in another entity if the sum of its direct participation interests in the other entity and the direct participation interests of its associates in the other entity is 10 per cent or more. The focus on direct participation interests under the non-portfolio interest test better targets the type of interest that an IMR foreign fund has in the other entity. Moreover, the aggregation of associates' interests ensures that an entity cannot circumvent the IMR rules by interposing a number of subsidiaries, each holding a separate portfolio interest in an entity.

1.175 In contrast to the current test (which prevents certain financial arrangements from being covered by section 842-245 where an IMR foreign fund has a total participation interest of 10 per cent or more), the treatment that follows from an IMR foreign fund having a non-portfolio interest applies to any financial arrangements that the fund has with that entity. As such, if another arrangement or a combination of arrangements

resulted in the IMR foreign fund having a direct participation interest of 10 per cent or more in the other entity, the IMR foreign fund would have a non-portfolio interest in determining the treatment of all of the financial arrangements that it has with the other entity.

1.176 The amendments extend the existing conduit income measure (element 2) to cover financial arrangements with entities in which an IMR foreign fund holds a non-portfolio interest. As such, the non-portfolio interest test is not included in the criteria related to financial arrangements to which the IMR applies. This has the effect of broadening the range of returns or gains that can qualify as IMR income or IMR capital gains. ***[Schedule #, items 7 and 8, subsections 842-245(1) and (2)]***

1.177 The non-portfolio interest test is however introduced under the rules relating to IMR income. Under those provisions (discussed in further detail below at paragraphs 1.192 to 1.200), the non-portfolio interest test performs a new role in applying the IMR income rules to returns or gains from financial arrangements with entities in which an IMR foreign fund has a non-portfolio interest.

1.178 In contrast to IMR income, whether an amount relates to a financial arrangement with an entity in which an IMR foreign fund holds a portfolio interest or a non-portfolio interest is no longer relevant for determining whether the amount is an IMR capital gain or IMR capital loss (IMR capital gains and IMR capital losses are discussed in further detail below at paragraphs 1.201 to 1.204).

General alignment with Division 855

1.179 Division 855 provides foreign residents with an exemption from capital gains tax for gains made from assets not taxable Australian property. The table to section 855-15 sets out the CGT assets that are taxable Australian property. These assets include taxable Australian real property, indirect Australian real property interests, CGT assets used in carrying on a business through an Australian permanent establishment, as well as options or rights to acquire any one of those assets.

1.180 One of the principal objectives of the IMR is to remove any uncertainty faced by foreign resident investors investing through widely held foreign managed funds in determining whether a return or gain made in Australia is on revenue or capital account. As a general proposition, this is achieved by ensuring that, where a return or gain would be exempt under Division 855 if it were made on capital account, it will be exempt if it is instead made on revenue account.

1.181 In some circumstances, the IMR provides an exemption from Australian tax for capital gains from certain taxable Australian property.

To the extent this exemption applies, a similar exemption for returns or gains on revenue account applies in relation to taxable Australian property of that kind. Where, taking into account the operation of both Division 855 and the IMR, a foreign resident's capital gains from certain taxable Australian property continue to be taxable in Australia, the IMR does not exclude comparable returns or gains made on revenue account.

Taxable Australian real property

1.182 Taxable Australian real property consists of assets such as Australian real property, leases over Australian real property, and rights over minerals located in Australia. The IMR cannot apply to returns or gains from CGT assets that are themselves Australian real property because of the requirement that a return or gain must be in relation to a financial arrangement.

1.183 The existing rule about derivative financial arrangements in respect of taxable Australian real property is modified so that financial arrangements that are themselves taxable Australian real property (such as leases over Australian real property or mining rights) are not covered by the IMR. ***[Schedule #, item 9, paragraph 842-245(3)(a)]***

1.184 Although this rule applies to IMR income and IMR capital gains, a gain or loss from a financial arrangement that is also taxable Australian real property cannot be an IMR capital gain or an IMR capital loss. Those rules each require the return or gain from a financial arrangement to be a CGT asset covered by item 3 of the table to section 855-15 (or an option or right to acquire a CGT asset of this kind), and that table item is explicitly precluded from applying to CGT assets that are also taxable Australian real property.

Indirect Australian real property interests

1.185 An indirect Australian real property interest is a non-portfolio interest in an entity whose assets are principally comprised of taxable Australian real property (for example, a land-rich company).

1.186 Given that Australian real property interests require a non-portfolio interest in an entity, the restriction of the current rules to financial arrangements with entities in which an IMR foreign fund holds a total participation interest of less than 10 per cent will generally have the effect of excluding any financial arrangement that the IMR foreign fund has with another entity in which it holds an indirect Australian real property interest.

1.187 Although the total participation interest test is removed from the criteria for financial arrangements, the existing rule in respect of

derivative financial arrangements over indirect Australian real property interests is modified (consistent with changes in respect of taxable Australian real property), so that a financial arrangement that is an indirect Australian real property interest is not covered by the IMR. ***[Schedule #, item 9, paragraph 842-245(3)(a)]***

1.188 Although this rule applies to IMR income and IMR capital gains, a gain or loss from a financial arrangement that is also an indirect Australian real property interest cannot be an IMR capital gain or an IMR capital loss. The rules in respect of IMR capital gains and IMR capital losses require the return or gain from a financial arrangement to be a CGT asset covered by item 3 of the table to section 855-15 (or an option or right to acquire a CGT asset of this kind), and that table item is explicitly precluded from applying to CGT assets that are also indirect Australian real property interests.

Options or rights to acquire taxable Australian property

1.189 Currently, the IMR specifically excludes derivative financial arrangements that relate to either taxable Australian real property or indirect Australian real property interests. This restriction is broadly maintained, although it is amended to refer to a financial arrangement that 'relates to' a CGT asset that is taxable Australian real property or an indirect Australian real property interest. ***[Schedule #, item 9, paragraph 842-245(3)(a)]***

Application of the IMR to certain taxable Australian property

1.190 Although the IMR generally seeks to ensure Australia retains its taxing rights over returns or gains from taxable Australian property, an exception to this is the extension of the capital gains tax exemption in circumstances for gains on CGT assets used in carrying on a business through an Australian permanent establishment.

1.191 This was a key component of element 2 of the IMR which was designed to ensure that foreign funds that use Australian intermediaries are not subject to Australian tax on certain income that, in the absence of the Australian intermediary, would otherwise be foreign sourced income.

Changes to IMR income

1.192 To qualify as IMR income under the current rules, a return or gain from a financial arrangement must otherwise form part of an IMR foreign fund's assessable income as the result of it being Australian sourced income because it is attributable to an Australian permanent establishment of the fund which exists only because the fund engaged an Australian intermediary. Given the types of financial arrangements that

are currently covered by section 842-245, an amount can only be IMR income if it is a return or gain from a financial arrangement with an entity in which the IMR foreign fund holds a total participation interest of less than 10 per cent.

1.193 The amendments therefore rewrite the existing provisions related to IMR income in order to give effect to two fundamental changes to their scope. The first change relates to the implementation of element 3 of the IMR, which removes the requirements in respect of permanent establishments for financial arrangements with entities in which an IMR foreign fund holds a portfolio interest. The second key change extends element 2 of the IMR (the conduit income measure), so that it applies to financial arrangements with entities in which an IMR foreign fund has a non-portfolio interest.

1.194 A result of these changes is that the treatment as IMR income of a return or gain from a financial arrangement will vary depending on whether the financial arrangement is with an entity in which an IMR foreign fund holds a portfolio interest or a non-portfolio interest. To facilitate this distinction, the non-portfolio interest test is now included in the rules relating to IMR income. ***[Schedule #, item 10, paragraph 842-250(1)(b)]***

Financial arrangements with entities in which an IMR foreign fund holds a portfolio interest

1.195 If a return or gain is attributable to a financial arrangement that an IMR foreign fund has with an entity in which it does not hold a non-portfolio interest, the return or gain can be IMR income to the extent that it would have otherwise been included in the assessable income of the fund. ***[Schedule #, item 10, paragraph 842-250(1)(a)]***

1.196 This outcome is achieved by limiting the existing requirements in respect of permanent establishments to financial arrangements with entities in which the IMR foreign fund holds a non-portfolio interest.

Financial arrangements with entities in which an IMR foreign fund holds a non-portfolio interest

1.197 Where an IMR foreign fund holds a non-portfolio interest in another entity, returns or gains from financial arrangements with that other entity can only be IMR income if they are attributable to an Australian permanent establishment of the fund that exists solely as a result of the IMR foreign fund engaging an Australian resident to habitually exercise a general authority to negotiate and conclude contracts on its behalf. ***[Schedule #, item 10 paragraph 842-250(b)]***

1.198 In addition to the existing requirements in respect of permanent establishments, further rules are included to ensure that the conduit income measure applies to foreign assets only. As such, a return or gain from a financial arrangement that is attributable to the relevant type of Australian permanent establishment will only be IMR income, if the income from the return or gain is Australian sourced, but would be foreign sourced had the fund negotiated and concluded all the contracts on its own behalf that were actually negotiated or concluded by its Australian permanent establishment. ***[Schedule #, item 10, subparagraphs 842-250(1)(b)(i) and (ii)]***

1.199 These additional rules are included to ensure that the conduit income measure cannot apply to assets that would give rise to Australian sourced income had the fund invested in them directly. For example, where a fund enters into a financial arrangement with another foreign entity (in which it holds a non-portfolio interest), it would be expected that, by disregarding the activities undertaken on its behalf by an Australian intermediary, the returns or gains to the fund would have a foreign source. Such amounts would be IMR income of the fund, even though they would have an Australian source having regard to the activities undertaken by the entity through its Australian permanent establishment.

1.200 In contrast, if an IMR foreign fund received a return or gain from a financial arrangement with an Australian resident entity that was listed on the Australian stock exchange (and in which it held a non-portfolio interest), the return or gain would be expected to be Australian sourced income irrespective of whether the IMR foreign fund engaged the Australian intermediary or not. As such, the return or gain would not qualify as IMR income under the conduit income measure.

Changes to IMR capital gain and IMR capital loss

1.201 Division 855 exempts foreign residents from capital gains tax in respect of gains from CGT assets that are not taxable Australian property. Given the coverage of Division 855, the exemption from capital gains tax under the IMR in relation to IMR capital gains is much more limited than that provided for IMR income (the exemption for IMR income is largely to align treatment of returns and gains on revenue account with the treatment currently provided under Division 855).

1.202 The IMR does however provide an exemption from capital gains tax in respect of some CGT assets that are taxable Australian property. This exemption is limited to those CGT assets that are covered by item 3 of the table in section 855-15, being CGT assets used in carrying on a business through the relevant type of Australian permanent establishment, and that are not taxable Australian real property or indirect Australian real

property interests. The IMR also disregards capital gains from CGT assets that are options or rights to acquire CGT assets of this kind.

1.203 Removing the non-portfolio interest test from the financial arrangement criteria in section 842-245 expands the application of the IMR capital gain provisions to gains from financial arrangements with entities in which an IMR foreign fund holds a non-portfolio interest. As IMR capital gains only relate to CGT assets used in carrying on a business through a permanent establishment in Australia, the permanent establishment rules contained in the IMR capital gain and IMR capital loss provisions continue to apply to gains from financial arrangements with entities in which an IMR foreign fund holds a portfolio interest.

1.204 The amendments make minor wording changes to the IMR capital gain and IMR capital loss rules that require a gain or loss to be from a financial arrangement that is covered by section 842-245 as well as subsection 842-255(3) itself (which imposes the requirement that the financial arrangement be a CGT asset covered by item 3 of the table in section 855-15 or by item 4 of that table insofar as it relate to item 3). These changes clarify the relationship between the relevant provisions but do not change their substantive application. ***[Schedule #, items 13 and 15 to 18, paragraphs 842-255(1)(b) and (2)(b) and subsection 842-255(3)]***

Other technical amendments

References to 'resident of Australia'

1.205 Subdivision 842-I currently contains a number of references to an entity being 'a resident of Australia'. This term 'resident of Australia' is defined in the ITAA 1936, whereas the ITAA 1997 (in which Subdivision 842-I is located) uses the term 'Australian resident' (which itself refers to the ITAA 1936 definition). The amendments ensure that Subdivision 842-I uses the correct terminology. ***[Schedule #, items 5, 11, 12 and 14, paragraphs 842-215(2)(a) and 842-255(1)(a) and (2)(a)]***

Pre-2012 IMR income and pre-2012 IMR capital gains

1.206 The rules in respect of pre-2012 IMR income and pre-2012 IMR capital gains draw directly on the provisions related to financial arrangements covered by section 842-245. The amendments change the types of arrangements covered by that section by removing the total participation interest test. To ensure that the pre-2012 IMR income and pre-2012 IMR capital gains rules continue to apply as intended, a specific rule is included to disregard the removal of that test from section 842-245 for the purposes of determining an IMR foreign fund's pre-2012 IMR income and pre-2012 IMR capital gains. ***[Schedule #, item 19, subsection 842-270(2A)]***